No. 80-1700

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In the Supreme Court of the United States

OCTOBER TERM, 1980

AUDREY M. THOMPSON, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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TABLE OF AUTHORITIES

Page

Cases:

Benenson v. *United States*, 385 F. 2d 26 7

Bob Jones University v. *Simon*, 416 U.S. 725 7

Commissioner v. *Gooch Milling & Elevator Co.*, 320 U.S. 418 6

Commissioner v. *Smith Paper, Inc.*, 222 F. 2d 126 6

J.B.N. Telephone Co. v. *United States*, 638 F. 2d 227 7

LTV Corp. v. *Commissioner*, 64 T.C. 589 6

Morse v. *United States*, 494 F. 2d 876 6

Moultrie Cotton Mills v. *United States*, 151 F. Supp. 482 7

W.W. Windle Co. v. *Commissioner*, 550 F. 2d 43 7

Statutes and regulation:

Internal Revenue Code of 1954 (26 U.S.C.):

Section 704(d) 5
Section 736 5
Section 741 5
Section 1311 7
Section 1312 7
Section 1313 7
Section 1314 7
Section 1314(b) 7
Section 6214(a) 6

Page

Statutes and regulation—Continued:

Section 6214(b) 6
Section 6512(b) 6
Section 7442 6
Treasury Regulations on Income Tax,
Section 1.1314(b)-1(a) (26 C.F.R.) 7

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The question presented by the petition in this federal income tax case is whether the Tax Court, having disallowed certain claimed deductions for the years in issue, was required to decide whether the disallowed deductions would result in adjustments to basis that could affect petitioners' taxable income in subsequent years. We submit that the Tax Court was not required to decide the basis question, and that, at all events, that question is not properly before this Court because it was not properly before the Tax Court or the court of appeals and therefore was never raised below.

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* In addition to the named parties, several other persons, who are or were members of the partnerships or shareholders of the entities involved in this case, have stipulated that the decision below will govern the outcome of those issues in their cases as well. A list of these persons is set forth in the Tax Court opinion (Pet. App. 7 n.1).

The pertinent facts may be summarized as follows:

a. *Florence Ain and Gregory Ain.* In August 1965, Aruba Bonaire Curacao Trust Company (ABC), a Bahamian trust company, through a shell corporation, Douglas R. McAvoy Organization (McAvoy), purchased some land from Sunset International Petroleum Corporation (Sunset) known as Thousand Oaks. In order to finance the transaction, ABC contributed $650,000 in cash to the capital of McAvoy. McAvoy agreed to purchase the land from Sunset for $700,000, payable under a 10-year 10% promissory note. Interest for the first four years ($280,000) was paid in advance. McAvoy also retained Sunset to construct a shopping center and apartment buildings on the land. In return for arranging the financing, McAvoy paid Sunset a financing fee of $370,000 in advance (Pet. App. 30-34).

McAvoy and Sunset then formed a joint venture which leased the property from McAvoy, assumed all financing costs, and agreed to pay all other costs and expenses relating to the property. The lease granted the joint venture an option to purchase the property; the joint venture agreement provided that the option would be exercised at a price not to exceed $1,600,000, and that Sunset would provide all the funds to exercise the option. Sunset also had exclusive power to manage and even to sell the joint venture's interest in the leasehold (Pet. App. 34-38).

In October and November of 1965, ABC sold 98% of the McAvoy stock to 30 individuals, collectively referred to as the McAvoy investors, for $6,800,000 in unsecured promissory notes (Pet. App. 40-41). McAvoy's only asset, other than the prepaid interest and financing fees, was the $700,000 piece of land. ABC assigned the notes to World Minerals, N.V., a Bahamas corporation with close ties to ABC. During 1965, the McAvoy investors paid $475,000 to World Minerals, purportedly as interest on these notes

(Pet. App. 41-42)[1] On audit, the Commissioner disallowed the claimed interest deductions. In this proceeding brought by petitioners Florence Ain and Gregory Ain, who were included in the group of McAvoy investors, the Tax Court upheld the Commissioner, concluding that ABC's purported purchase of the property through McAvoy, followed by the sale of substantially all the stock of McAvoy itself at a price almost ten times the price of the land, was not a bona fide transaction (Pet. App. 96-97). The court of appeals affirmed. It found the transaction to be inexplicable in view of the unexplained increase in price (Pet. App. 23), and in view of Sunset's retained right to repurchase the property for $1,600,000 (Pet. App. 25).

b. *Audrey M. Thompson.* In 1966, Del Cerro Associates, a partnership, and the McAvoy investors entered into a new partnership, also called Del Cerro Associates. The members of the original partnership contributed their interest in other land purchased from Sunset, and the McAvoy investors contributed their stock in McAvoy. The new partnership also assumed the $6,800,000 obligation that the McAvoy investors owed to World Minerals. McAvoy was dissolved and the prepaid loan commitment fee of $370,000, and the prepaid interest of $245,000 ($280,000 net of amortization), which had been carried as assets on McAvoy's books, were carried forward onto the books of Del Cerro. McAvoy's investment in the Thousand Oaks property was recorded on the books of Del Cerro by the introduction of a new assets described as " 'Contractual Rights and Interests' " in the amount of $6,254,500 (Pet. App. 45-48).

The Del Cerro partners contributed $1,065,000 additional cash to the partnership in 1966 (Pet. App. 49). In its partnership return for 1966, Del Cerro claimed an interest

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[1]Of this amount, petitioner Florence Ain deducted $5,000 as her aliquot share of the partnership deduction (Pet. App. 43).

deduction of $1,070,000, consisting of $825,000 paid to World Minerals as interest on the $6,800,000 obligation, and $245,000, representing a write-off of the prepaid interest account carried over from the books of McAvoy (Pet. App. 51-52).[2] The Tax Court upheld the Commissioner's disallowance of the deductions on the grounds that the $6,800,000 of indebtedness was a sham (Pet. App. 97-98), and that the $245,000 had never been "paid" by the partnership, but was paid by McAvoy (Pet. App. 101). The court of appeals affirmed on the same ground (Pet. App. 27-28).

c. *William Berman.* During 1967, Sunset experienced serious financial difficulties, and renegotiated its agreements with Del Cerro concerning the Thousand Oaks property. Pursuant to the renegotiation, Del Cerro was relieved of personal liability on the notes used to purchase the Thousand Oaks property, and those and other notes became collateral for Sunset's obligation to exercise the repurchase option. Moreover, Sunset was required to pay Del Cerro $1,200,000 in cash or an equivalent amount of Commonwealth United Corporation (CUC) common stock. All other obligations of the parties to each other were cancelled, except that if Sunset failed to pay the $1,200,000 it would remain obligated to exercise the option to repurchase the property (Pet. App. 58-62).

Del Cerro also modified its agreement with World Minerals so that Del Cerro was relieved of any obligation to pay interest on the loan provided the loan was paid in full by December 31, 1970. Furthermore, Del Cerro was to transfer certain assets to World Minerals in partial payment of the debt (Pet. App. 63-66).

During 1967, the Del Cerro partners contributed an additional $1,178,317 to the partnership. Del Cerro reported a

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[2]Petitioner Thompson deducted $15,000 as her share of the partnership deduction (Pet. App. 52, 56).

net loss, resulting primarily from the write-off of the contractual rights and interests in the amount of $6,254,500 (Pet. App. 65-66). The loss was allocated among the taxpayers in some undisclosed manner (Pet. App. 67 n.17).[3] The Tax Court disallowed the loss on the grounds that the partnership had no tax basis in the contractual rights written off (Pet. App. 108), and the court of appeals affirmed (Pet. App. 30-31).

1. Petitioners do not challenge the correctness of the lower courts' findings (Pet. 5), nor do they claim any conflict with any other judicial decisions (Pet. 7). Rather, they appear to argue (Pet. 5-7) that their petition should be granted because the courts below failed to declare what effect the disallowed deductions had on their basis in the partnership in 1967.

The question of the partners' basis in the partnership in that year, however, was not properly before the Tax Court. If, in fact, the partnership had suffered the claimed losses, each taxpayer's basis may have been relevant to limit his or her share of the loss under Section 704(d) of the Code. Since petitioners do not challenge the disallowance of the interest and loss deductions, however, their basis in the partnership is relevant only for determining allowable losses in subsequent years, or in determining their ultimate gain or loss on disposition of their partnership interests. See Sections 736 and 741 of the Internal Revenue Code of 1954 (26 U.S.C.).

Petitioners do not claim that a dissolution of the partnership took place in 1967, nor do they claim that there were any sales of the partnership interests during the years in issue on which gain or loss would be realized. The Tax Court's jurisdiction, with exceptions not relevant here, is

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[3]Petitioner Berman claimed a loss of $19,937.35 as his share of the partnership loss (Pet. App. 67).

limited to determining deficiencies or overpayments of tax for the years in which the Commissioner has determined a deficiency and the taxpayer has filed a petition for review. *Commissioner* v. *Gooch Milling & Elevator Co.*, 320 U.S. 418, 420 (1943); *Morse* v. *United States*, 494 F. 2d 876, 879 (9th Cir. 1974); *Commissioner* v. *Smith Paper, Inc.*, 222 F. 2d 126, 129 (1st Cir. 1955). In the absence of some showing that petitioners' basis in the partnership would affect the correct determination of their tax liability in years before the Tax Court, the fact that the Tax Court did not make a gratuitous finding as to the amount of that basis was not error. *LTV Corp.* v. *Commissioner*, 64 T.C. 589 (1975); see also Sections 6214(a), 6512(b), 7442 of the Code.

2. Nor was the Tax Court required to determine petitioners' basis for their partnership interests simply because such basis may be relevant in a subsequent year. Petitioners' argument (Pet. 5) that it is incumbent on the Commissioner[4] and the courts to dispose of all the issues before them in any one proceeding or for any one tax year, regardless of whether the issues affect tax liability for that year, is wrong. As we have noted, the Tax Court is a court of limited jurisdiction, and Section 6214(b) of the Code specifically provides that the Tax Court may not determine whether the tax for years not before it may have been overpaid or underpaid. *Commissioner* v. *Gooch Milling & Elevator Co., supra.* Thus, even if the disallowance of expenses by the Tax Court in 1965, 1966 or 1967 resulted in basis adjustments that would affect the gain on disposition of the partnership interests in some subsequent year—a proposition that is not self-evident and must be established by taxpayers—the Tax Court would still have no jurisdiction to determine that ultimate gain or loss until deficiency

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[4]Although petitioners assert (Pet. 6) that this result is required by the Treasury Regulations, they fail to cite any specific Regulations in support of their contention.

notices for those years were issued, and petitions for redetermination were timely filed. Indeed, any finding as to basis under these circumstances would closely resemble a declaratory judgment with respect to taxes, which, with exceptions not here relevant, is beyond the Tax Court's jurisdiction. *LTV Corp.* v. *Commissioner, supra; W.W. Windle Co.* v. *Commissioner,* 550 F. 2d 43, 45-46 (1st Cir. 1977). See generally *Bob Jones University* v. *Simon,* 416 U.S. 725, 732 n.7 (1974).

Finally, petitioners' reliance (Pet. 7-8) upon the mitigation provisions of the Internal Revenue Code of 1954 (Sections 1311 through 1314) is misplaced. Generally, the mitigation provisions afford the taxpayer (or the Commissioner) additional time to adjust certain errors in taxable years otherwise barred by the statute of limitations if those errors are inconsistent with a determination (defined in Section 1313) for another taxable year. If petitioners can prove that they treated an item on their returns for a time-barred year in a manner that is inconsistent with the Tax Court's decision here, and if they can prove that they meet the specific requirements of Sections 1311 and 1312, Section 1314(b) allows them to file a claim for refund with respect to the item inconsistently treated within one year from the date the Tax Court decision becomes final. Thus, at most, the mitigation provisions allow petitioners additional time to file refund claims. *Benenson* v. *United States,* 385 F. 2d 26, 31, 33-34 (2d Cir. 1967); *J.B.N. Telephone Co.* v. *United States,* 638 F. 2d 227, 236-237 (10th Cir. 1981). Treasury Regulations on Income Tax, Section 1.1314(b)-1(a) (26 C.F.R.).[5] If the Commissioner denies the claim, petitioners

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[5] *Moultrie Cotton Mills* v. *United States,* 151 F. Supp. 482 (Ct. Cl. 1957), holding that an additional refund claim for later years is unnecessary, is not to the contrary. In that case, the initial claim for refund covered all the years in issue and specifically invoked the mitigation provisions.

may then sue for a refund in the district court or in the Court of Claims. The crucial point to be made in this context is that the mitigation provisions do not allow the Tax Court to decide tax liability for years not properly before it, nor do they expand the Tax Court's statutory jurisdiction to include declaratory judgments or refund claims.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

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